

Office of Chief Counsel
Internal Revenue Service

memorandum

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JSHargis

date: June 21, 1999

to: Chief, Examination Division, Southern California District
Josephine Robinson and Suellen Casey

from: District Counsel, Southern California District, Laguna Niguel

subject: [REDACTED], [REDACTED];
Lease Assumption Liability

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ISSUE

Whether [REDACTED], ([REDACTED]) must capitalize payments made to its tenants' former landlords to obtain the tenants' release from their prior leases so that they might become tenants of [REDACTED].

CONCLUSION

Yes. [REDACTED] must capitalize these payments and amortize them over the term of the lease entered into by its new tenant.

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FACTS

██████████ is in the business of building and managing large office buildings throughout the United States. As an inducement to new, desirable tenants, ██████████ sometimes takes over the prospective tenant's liability on its current lease. ██████████ currently deducts all payments made pursuant to such assumptions. For its taxable year ended December 31, ██████████, ██████████ deducted \$██████████ with regard to tenants in just one of its properties, known as ██████████. The majority of this amount, \$██████████ was paid with regard to ██████████ major tenants. In ██████████ paid another \$██████████ with regard to these ██████████ tenants. ██████████ paid another \$██████████ with regard to ██████████ tenants in another property, known as ██████████, during ██████████ and another \$██████████ in ██████████. These tenants all entered into leases with ██████████ lasting ██████████ or more years (██████████ years in one case). ██████████ generally negotiates an increased rate of rent from these tenants to offset the payments to the tenants' former landlords.

The fact pattern submitted to Counsel does not indicate whether the payments consist entirely of rental payments under the old leases or if there is a termination fee component. Nor is there an indication as to whether or not ██████████ successfully sublets the old premises after assuming the lease obligations. We assume the expenses being challenged are net of any income earned by ██████████ on the assumed leases.

LAW AND ANALYSIS

The principal issue for decision is whether the taxpayer is entitled to a section 162(a) deduction for expenditures incurred in relation to assuming its tenants' obligations under their old leases during the years in issue. Section 162(a) allows as a deduction "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business". To qualify as an allowable deduction under section 162(a), an item must: (1) Be paid or incurred during the taxable year; (2) be for carrying on any trade or business; (3) be an expense; (4) be a necessary expense; and (5) be an ordinary expense. Commissioner v. Lincoln Sav. & Loan Association, 403 U.S. 345, 352 (1971).

The issue is not whether the expenditures in issue were "paid or incurred during the taxable year", or whether the expenditures were "necessary" in the accepted sense of "'appropriate and helpful for the development of the [taxpayer's] business'". Id. at 353 (quoting Commissioner v. Tellier, 383 U.S. 687, 689 (1966)). The issue is whether any of the expenditures in issue can be deemed either an "expense" or an "ordinary expense" capable of deduction

under section 162. Id. at 354. A capital expenditure is not an "ordinary" expense within the meaning of section 162(a) and is therefore not currently deductible. Lincoln Sav. & Loan, supra at 353; see section 263(a). Capitalization under section 263 takes precedence over current deduction under section 162. See sections 161 and 261; and INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992).

In determining whether a cost is a capital expenditure, the Supreme Court in INDOPCO, supra, noted that deductions are exceptions to the norm of capitalization. The Court stated that deductions are specifically enumerated and thus are subject to disallowance in favor of capitalization. Capital expenditures, by contrast, are not exhaustively enumerated. Rather than providing a complete list of nondeductible expenditures, section 263 serves as a general means of distinguishing capital expenditures from current expenses.

A business expense is currently deductible, while a capital expenditure is normally amortized and depreciated over the life of the relevant asset or benefit, or, if no specific asset or useful life can be ascertained, is deductible upon dissolution of the enterprise. Id. at 83-84 (1992). Whether an expenditure may be deducted or must be capitalized is a question of fact. The "decisive distinctions" between current expenses and capital expenditures "are those of degree and not of kind". Id. at 86 (quoting Welch v. Helvering, 290 U.S. 111, 114 (1933)). "One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle." Id. at 115.

An expenditure is almost always capital if it creates or enhances a separate and distinct asset. The existence of a separate and distinct asset, however, is not necessary in order to classify an expenditure as capital in nature. INDOPCO, supra. It may be necessary to capitalize an expenditure simply because it provides the taxpayer with long-term benefits. Id. at 87. On the other hand, if an expenditure produces a separate and distinct asset, it will almost certainly have to be capitalized. See PNC Bancorp, Inc. v. Commissioner, 110 T.C. ____ (1998).

A lease is clearly an asset. See, e.g., Helvering v. Lazarus & Co., 308 U.S. 252 (1939); U.S. Bancorp v. Commissioner, 111 T.C. ___, No. 10., Filed September 21, 1998; and Montgomery Co. v. Commissioner, 54 T.C. 986 (1970). Generally, a discretionary sum paid by a landlord to a tenant should be capitalized by the landlord and amortized over the term of the lease. Bonwit Teller & Co. v. Commissioner, 17 B.T.A. 1019 (1929), rev'd on other grounds,

53 F.2d 381 (2d Cir. 1931), but not necessarily over option periods.¹ See also Rev. Rul. 81-161, 1981-1 C.B. 313, ruling that certain fees paid in connection with the development of a low-income housing complex must be capitalized and amortized over the term of leases or the loan term. Cf. Daly v. Anderson, 37 F.2d 728 (S.D.N.Y. 1928) (leasing agent's commission deductible in year paid). The requirement for amortization over the term stems from general principles of tax law and accounting rather than clearly laid out authority. It is based upon "exhaustion" of the underlying asset (the lease). See Reg. section 1.461-1(a)(1) limiting the deduction to be taken in connection with the acquisition of assets having useful lives of over one year.

There is an interrelationship between the two leases that require the assumption costs to be treated as a cost of acquiring the new lease. While the properties covered by the two leases are not identical, they are similar in that both are commercial real estate used for the same purposes in the tenant's business. Cf. section 1031(a); Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652 (5th Cir. 1968); Coastal Terminals, Inc. v. United States, 320 F.2d 333 (4th Cir. 1963); section 1.1031(a)-1(c); Rev. Rul. 61-119, 1961-1 C.B. 395. The interrelationship between the assumption and the new lease will seem especially strong if the execution of the new lease was expressly conditioned on the assumption of the old lease. We suggest that you attempt to determine if this is the case.

Most of the cases are factually distinguishable from the case at hand--usually because only two parties are involved and the transaction is a renegotiation between landlord and tenant. In this case, three parties are involved. We believe that this factual distinction merely serves to prove that the payments were made to acquire the new lease. Most of the two party cases focus on the purpose of the payments, holding that if the purpose was to obtain the new lease, then capitalization is necessary. That was clearly the purpose of [REDACTED]'s payments.

Unfortunately, the only case that seems to be factually on point is 379 Madison Ave. v. Commissioner, 60 F.2d 68 (2d Cir.

¹ If the lease contains options, the question necessarily arises whether amortization of the payments must be spread over the option period(s) as well. The general rule seems to be that the option periods may be disregarded unless the economics of the deal make the options certain to be exercised. See Jos. N. Neel Co. v. Commissioner, 22 T.C. 1083 (1954) (amortization of improvements made by tenant in lieu of rent--second option not certain to be exercised).

1932), which squarely rules that such costs are currently deductible.² We believe that the reasoning of the court in that case is suspect, especially in light of INDOPCO, supra.³ In addition, we note that the Service won 379 Madison Ave. in the Tax Court. The Tax Court has given no indication that it has changed its views on this issue. If recent, similar cases are any indication, the Tax Court would rule in favor of the Service again on similar facts. See U.S. Bancorp, supra. In addition, the adverse opinion in 379 Madison Ave. was issued many years ago by the Second Circuit. [REDACTED] is not in the Second Circuit, thus the precedent is not binding. Golsen v. Commissioner, 54 T.C. 742, 757 (1970), aff'd, 445 F.2d 985 (10th Cir. 1971). Finally, we note that the Service has given no indication that it has changed its position from that which it took in 379 Madison Ave.

CONCLUSION

[REDACTED] must capitalize these payments and amortize them over the term of the lease entered into by its new tenant. 379 Madison Ave. may pose a litigating hazard, but the hazard seems small and Service position and policy seem clearly and strongly in favor of seeking capitalization.

J. SCOTT HARGIS
Attorney

² We note that the case dealt with the taxpayer's net loss from the transaction. It was assumed by all involved that the lease payments made by the new landlord on the old lease of the tenant were deductible to the extent of the rent paid by the new sublessee obtained by the landlord to defray its expenses. This seems to be the correct result. As we mentioned earlier, we do not know if the landlord simply assumed these leases or paid fees to the old landlords to break the leases.

³ The Service has won several cases after INDOPCO with facts that seem less favorable than those here. U.S. Bancorp, supra; PNC Bancorp, supra; and FMR Corp. v. Commissioner, 110 T.C. (1998). The Service appears to be aggressively seeking capitalization of expenses either where an asset was acquired or where there were significant long term benefits. The only exceptions seem to be for advertising expenses, Rev. Rul. 96-62, 1996-2 C.B. 8, and training costs, Rev. Rul. 92-80, 1992-2 C.B. 163.